[redacted]
TL-N-8852-89 [redacted]
CC:TL:Br3 Mustone Hall
I.R.C. sections 162 & 461
VEBA, contributions, CEP

Internal Revenue Service
memorandum

CC:TL:Br3
DAMustone

date: OCT 17 1989

to: Beth L. Williams, Special Trial Attorney
Regional Counsel, Midwest Region MW

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Technical Advice - [redacted] (TL-N-8852-89).

It has been requested that we provide technical assistance with respect to the above case. The issue involved is reported in the current CEP Tracking Report.

ISSUE

Whether the taxpayer properly deducted in the [redacted] taxable year, a contribution of $[redacted] made to the [redacted] (hereinafter "Trust") at the end of that year to fund group insurance medical benefits for its active employees.

CONCLUSION

We believe that the prepayment and accrual issues raised in the Notice of Deficiency are not defensible in the context of this case. As to the capitalization issue and the applicability of Temp. Treas. Reg. § 1.419-1T (Q&A-10(c)), further factual development is needed in order to evaluate the worth of these items.

FACTS

On [redacted], [redacted] established the Trust in order to fund the benefits provided under various welfare benefit plans maintained for its employees. The plans apparently provide for a number of welfare-type benefits, including medical insurance. The Trust purportedly qualifies for tax exempt status under I.R.C. § 501(c)(9) as a voluntary employees beneficiary association (VEBA).

On [redacted], [redacted] contributed $[redacted] to the Trust. Of this amount, it is claimed that $[redacted] was for "medical expenses of active employees that [[redacted]] reasonably expected to pay within the next taxable year ... ." Petition, ¶ 5(a)(vi). It is not clear how the taxpayer determined this amount. Nor is there anything which shows how much was expended

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for the medical expenses of active employees in either the [redacted] or [redacted] taxable years. The taxpayer presumably uses the accrual method of accounting for income tax purposes.

In the Notice of Deficiency, the district disallowed the $[redacted] paid for future medical benefits as a deduction for the [redacted] taxable year. As grounds for this disallowance, it is claimed that that amount constitutes a capital expenditure and a nondeductible prepayment of a future expense and that it does not satisfy the "all events" test. It was also concluded that the taxpayer was not entitled to the relief provided for in Q&A-10(c) of Temp. Treas. Reg. § 1.419-1T.

DISCUSSION

At the outset, it is clear that several of the theories raised in the Notice of Deficiency are without merit. First, even with United States v. General Dynamics Corp., 481 U.S. 239 (1987), there is no real basis for claiming that the "all events" test has not been satisfied in the circumstances involved. Thus, unlike the medical plan involved in General Dynamics (which was unfunded), the plan here is funded through a separate trust. And, where a welfare benefit plan is so funded, it is Service position that the "all events" test (which is now codified in I.R.C. § 461(h)) is satisfied when the contribution is made to the trust.[1/] See Temp. Treas. Reg. § 1.419-1T (Q&A-10(e)) & § 1.461(h)-4T (Q&A-1). See also VEBA Audit Guideline, at 2 (a copy of which is attached). Second, the prepayment doctrine only applies to cash basis taxpayers and therefore, is inapplicable in this case. See, e.g., Packard v. Commissioner, 85 T.C. 397, 422-23 (1985); Grynberg v. Commissioner, 83 T.C. 255, 264 (1984).

In addition, if the disputed amount was in fact expended in the next taxable year for medical claims as petitioners claim, the capitalization theory is also of doubtful merit. Thus, even though a reserve with a useful life beyond the year was created, it will be difficult to convince a court that the entire reserve has a useful life "substantially" beyond that year as the regulations require. See §§ 1.419-1T (Q&A-10(b)) & § 1.461-1(a)(2). See also Zaninovich v. Commissioner, 616 F.2d

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1/ As a technical matter, this would appear to be the correct conclusion since the contribution to a welfare benefit trust (where, as is apparently the case here, the contribution is generally nonrefundable) plainly fixes the liability and the amount of that liability (that is, the contribution made) is clearly determinable with reasonable accuracy.

429, 432 (9th Cir. 1980) (one-year rule for capitalization). Hence, what is crucial here is whether all or substantially all of the amount contributed is expended by the Trust in the next taxable year. If this occurred, the hazards are considerable. Moreover, the Service is, as practical matter, not generally interested in litigating such a case for years prior to the effective date of I.R.C. § 419. See generally VEBA Audit Guideline, at 3.

Lastly, the Notice is also mistaken as to the potential applicability of the relief provided for in Q&A-10(c) of § 1.419-1T. Under this Q&A, I.R.C. § 7805(b) relief is given for pre-1986 years for those deductions which satisfy the standards applied in certain revenue rulings, as "modified as appropriate for benefits for active employees." However, the relief provided is not, as the Notice of Deficiency appears to suggest, available on an "all or nothing" basis. Rather, as reflected in the VEBA Audit Guideline, relief is to be provided to the extent that the applicable standards are satisfied. See id., at 4. Accordingly, only that portion of a disputed contribution which exceeds those standards should be pursued.

The VEBA Audit Guideline is also relevant in determining the extent to which relief should be accorded under Q&A-10(c) in this context. While it is not technically binding in litigation, the Guideline was designed to set the parameters as to what would be pursued for pre-1986 years. Thus, it was generally intended that the Service would not litigate those proposed adjustments which would not be set up under the Guideline.2/ With regard to the case at hand, the Guideline provides that contributions for medical benefits will be presumed to satisfy Q&A-10(c) where, inter alia, the reserve at the end of the year either (1) represents 133 % of the costs for the subject benefits during that year or (2) did not exceed the costs for such benefits in the following taxable year. To the extent the disputed contribution satisfies either standard, we recommend that the deduction be conceded. Therefore, it will be necessary to ascertain the actual cost of benefits for the two years involved in order to determine the appropriate course of action to be taken under Q&A-10(c).

2/ And, from a practical standpoint, this makes good sense since the Guideline is available to the public. Accordingly, they could potentially have an adverse impact in a case involving this issue if brought to the court's attention.

If you need any further assistance in this case, please contact David Mustone of the Tax Litigation Division at FTS 566-3407.

MARLENE GROSS

By: Sarah A. Hall
SARAH A. HALL
Employee Plans
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Attachment:
VEBA Audit Guideline.